# DNR Capital Australian Equities High Conviction Fund

## Performance Report – February 2022

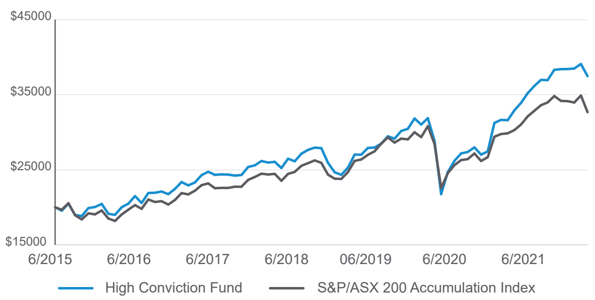
### Performance

The S&P/ASX 200 Accumulation Index was up 2.14% during the period.

Energy (+5.8%) was the best performing sector, as an already tight oil and gas market was rocked by the Russian invasion of Ukraine and the subsequent sanctions on Russia. Consumer Staples (+5.6%) also outperformed as a flight to safety and strong half-year reports from companies such as Endeavour Group (EDV +14.0%) propelled the sector higher. Information Technology (-6.9%) was the worst performing sector, with the rotation from growth to value continuing and a newfound focus on profitability in reporting season. Consumer Discretionary (-5.8%) also underperformed, with key constituents Wesfarmers (WES -8.6%), Aristocrat Leisure (ALL -7.6%) and Domino's Pizza Enterprises (DMP -23.7%) all reporting against strong comparative periods.

DNR Capital Australian Equities High Conviction Fund outperformed the Index for the month. Key stock contributors were Woodside Petroleum (WPL), South32 (S32) and Computershare (CPU). Key stock detractors were Westpac Banking Corporation (WBC, No Holding), Aristocrat Leisure (ALL), and SEEK (SEK).

### Growth of $20,000 since inception




*Source: Mainstream Fund Services and DNR Capital*

### Top 10 active holdings

| Security details | Active weight % | Actual weight % |
|---|---|---|
| National Australia Bank | 4.39 | 8.97 |
| Tabcorp Holdings | 4.17 | 4.71 |
| Lendlease | 3.81 | 4.16 |
| Woodside Petroleum | 3.73 | 5.05 |
| Macquarie Group | 3.32 | 6.41 |
| QBE Insurance Group | 3.18 | 4.01 |
| Aristocrat Leisure | 3.11 | 4.32 |
| Computershare | 3.09 | 3.69 |
| Scentre | 3.01 | 3.78 |
| Suncorp Group | 2.86 | 3.54 |

*Source: Mainstream Fund Services and DNR Capital*

### Fund overview

| | |
|---|---|
| APIR Code | PIM0028AU |
| Investment bias | Style neutral with a quality focus |
| Designed for | Investors seeking a medium-term investment focused on achieving growth, with less focus on generating excess income. The investor is prepared to accept higher volatility in pursuit of higher growth. |
| Investment objective | To invest in a high conviction portfolio of Australian equities that aims to outperform the Benchmark by 4% p.a. over a rolling three-year period. The investment objective is not a forecast of the Fund's performance. |
| Benchmark | S&P/ASX 200 Accumulation Index |
| Investable universe | Australian equities and cash |
| Investment constraints | The Fund will not invest in derivatives. |
| Investment guidelines | Maximum exposure to an individual security is 15% of Fund NAV<br>Minimum exposure of 80% of the Fund NAV to be invested in the S&P/ASX 200 |
| Asset allocation | Australian Equities – 80-100%<br>Cash – 0-20% |
| Risk level | High |
| Number of securities | Min 15 - max 30, typically 25 |
| Minimum suggested investment timeframe | 5 years |
| Buy/sell spread | +0.20% / -0.20% |
| Management fee | 0.90% ( inclusive GST and RITC) |
| Minimum initial application amount | $20,000 |
| Minimum further application amount | $5,000 |
| Minimum withdrawal amount | $5,000 |
| Valuation and unit pricing frequency | Each business day |
| Distribution frequency | Semi-annual |
| Responsible entity | The Trust Company (RE Services) Limited as part of the Perpetual Limited group of companies |
| Entry/exit fees | Nil |

## Net active return as at 28 February 2022

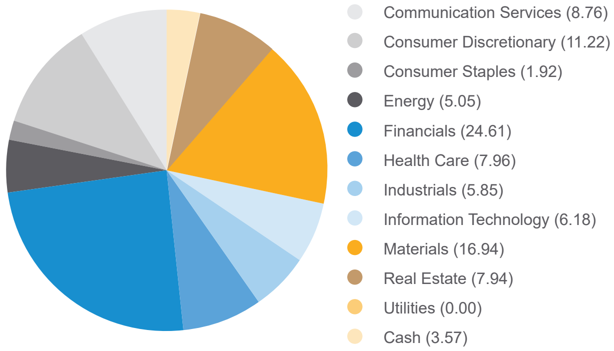
| | 1mth % | 3mth % | 6mth % | 1yr % p.a. | 3yr % p.a. | 5yr % p.a. | Incep.* % p.a. |
|---|---|---|---|---|---|---|---|
| High Conviction Fund | 3.29 | 0.55 | 1.01 | 17.57 | 12.72 | 10.67 | 10.32 |
| S&P/ASX 200 Accumulation Index | 2.14 | -1.72 | -4.15 | 10.19 | 8.43 | 8.48 | 7.91 |
| **Excess return** | **1.15** | **2.27** | **5.16** | **7.38** | **4.29** | **2.19** | **2.41** |

** Inception Date—June 2015*

*Source: Mainstream Fund Services and DNR Capital*

*Past performance is not an indication of future performance. Total return shown for the DNR Capital Australian Equities High Conviction Fund has been calculated using exit prices after taking into account all of the product's ongoing fees and assuming reinvestment of distributions. No allowance has been made for entry fees or taxation.*

## Sector weightings %




*Source: Mainstream Fund Services and DNR Capital*

## Attribution

The top stock contributors for the month were:

- **Woodside Petroleum (WPL):** outperformed during the period, with energy prices surging beyond $100 per barrel. The Russian invasion of Ukraine has caused severe disruptions to energy markets. Russia represents ~10% of global oil and gas supply and while sanctions have not yet been placed on Russia's energy exports directly, the risk of an extreme supply shock has elevated considerably.
- **South32 (S32):** rallied over the month as tightness in commodity markets saw strong spot commodity prices. The strength in alumina and aluminum pricing has been further supported by geopolitical uncertainty which has impacted the supply outlook.
- **Computershare (CPU):** enjoyed a strong result with recognition of the interest rate leverage causing greater interest in the company.

The top stock detractors for the month were:

- **Westpac Banking Corporation (WBC, No Holding):** bounced following its quarterly update which highlighted progress on cost out, meaning the underlying result was not as bad as feared.
- **Aristocrat Leisure (ALL):** was softer across the month with an acquisition designed to push it into the Real Money Gaming market being rebuffed. Later in the month, recognition that it had staff in the Ukraine likely weighed in the stock. ALL has noted no material impact is expected with two thirds of its staff moving to Poland.
- **SEEK (SEK):** underperformed the market in line with technology and classified peers, and despite a strong above-market earnings result and positive outlook.

## Market review

The month was a busy one with the Ukraine conflict overwhelming reporting season news. We discuss the implications of the war before reviewing the key observations from our bottom up analysis during reporting season.

### Implications of the war in Ukraine

1. **Economic disruption.** A global coalition is implementing a raft of economic sanctions on Russia. In turn, we expect Russia to interrupt European gas supply, increasing the cost of energy. The impact of higher energy prices on demand will likely have negative consequences for economic growth. Woodside Petroleum (WPL) would be a major beneficiary if gas prices stay elevated, with 20-25% of its volumes sold at spot prices. If gas prices remain at $50 mptu for six months, WPL earns an additional $1.5b.
2. **Germany has announced it will increase spending on defence by ~1% of GDP.** We expect other nations to follow suit, further cementing a willingness of governments to increase spending, a change that has been observed since the onset of COVID-19. This potentially adds to inflationary pressures and broader commodity prices.
3. **Uncertainty in markets usually presents buying opportunities, and we are selectively topping up our portfolios as they arise.** An example includes Macquarie Group (MQG) whose share price has fallen 20% since lifting earnings by 10% and it is a major beneficiary of energy volatility.
4. **Will a change to interest rates be delayed?** We doubt it, but acknowledge the US Federal Reserve may be more reluctant to increase as rapidly while the oil price acts as a brake on the economy. Technology stocks have been especially weak and potentially due a relief rally, but this could prove to be short lived (especially if inflationary risk remains elevated). Nonetheless, our experience shows buying high quality businesses impacted by primarily macro factors is productive, and we have topped up CSL (CSL).

5. **A caveat is that we are cognisant of political risks closer to home with regional sabre rattling and ongoing tensions between Canberra and Beijing.** China has aligned itself with Russia and refused to condemn its actions. Beijing's designs on Taiwan are well documented, and a lack of forceful retaliation from the West may embolden China's strategy to bring the island further under its influence.

Geopolitics, and increasingly hawkish central banks, have pushed market volatility higher, evidenced by large and wild intraday moves. Whilst using this volatility to selectively increase exposure to our high conviction positions, we view balance across the portfolios as warranted.

### Reporting season observations

#### Key positive surprises

Resources were strong reflecting surging commodity prices and better than expected cost control for the majors.

#### Mixed results

Banks were mixed, with soft underlying results for ANZ Banking Group (ANZ) and Commonwealth Bank of Australia (CBA), better than feared for Westpac Banking Corporation (WBC) and a strong result for National Australia Bank (NAB), reflecting a strong turnaround. The margin outlook continues to be challenged in the near term, albeit the change to the yield curve promises some relief further out.

Technology stocks were mixed with some positive surprises from economically sensitive names like SEEK (SEK) and WiseTech Global (WTC), but the market was tending to sell growth names through the month.

#### Key disappointments

Retail: overall most disappointed, notably Wesfarmers (WES), Super Retail Group (SUL), and City Chic Collective (CCX) – in large part due to material blowouts in stock inventories, transport costs and bottlenecks.

COVID-19 winners were struggling to maintain strong earnings momentum, highlighted by Ansell (ANN) and Domino's Pizza Enterprises (DMP) failing to meet already downwardly revised expectations.

Builders: Boral (BLD), and Reliance Worldwide Corporation (RWC) had large disappointments owing to lower volumes and pricing.

Technology Stocks: notable disappointments from several former darlings including Life360 (360), Nuix (NXL) and Tyro Payments (TYR) but punctuated by Appen (APX) losing a third of its value after being hit by Apple and Facebook's privacy enhancement and abandoning forward guidance.

#### Significant drivers & themes

1. Benefits of scale are back. Inflationary pressures mean good businesses with buying power have competitive advantages. We saw this with larger resource companies controlling costs better than smaller players, and larger insurance companies managing claims inflation relative to smaller competitors. We wonder whether larger companies (which have been under pressure from competitors in a digital world) will be better placed to compete by leveraging scale as costs rise.
2. COVID-19 winners struggled to hold market interest. Despite solid results, stocks such as Wesfarmers (WES), REA Group (REA) and ARB Corporation (ARB) gave up relative performance as the sustainability of margins and earnings was questioned by the market, as we cycle COVID-19 benefits.
3. Conversely, COVID-19 losers, including impacted property companies, performed well as the market looked beyond this extraordinary period.
4. A transition from "Just in Time" to "Just in Case" inventory management is leading to a surge in working capital, impacting cash flows. As an emerging "de-globalisation" thematic takes hold, many retailers will need to carefully manage working capital further to build inventory buffers.

## Fund commentary

### Best results

#### Computershare (CPU)

CPU saw large upgrades post result (~10%) as the market recognised the leverage it has to higher interest rates, given US$37b of client money sitting in cash. Furthermore, good progress has been made on its recent acquisition of the Wells Fargo's Corporate Trust business, while its COVID-19 impacted mortgage business has likely seen its low point.

#### Qube Holdings (QUB)

QUB delivered a result 7% better than consensus. Very strong revenue growth was reflective of a bounce-back in grain transportation, and good activity levels across logistics. Price increases, acquisitions and contract wins promise further growth, and earnings per share (EPS) will be enhanced by $400m worth of capital management (likely a buyback) in the second half.

### Worst result

#### Domino's Pizza Enterprises (DMP)

DMP was a significant COVID-19 beneficiary, and as activity normalises, growth rates are slowing. In particular, Japan has normalised faster than originally anticipated. We reduced our holding substantially last year, but remain attracted to the long-term growth opportunity.

## Fund positioning

We have positioned the Fund as follows:

- **Inflation hedges.** Exposure to a number of stocks that benefit from rising inflation such as Computershare (CPU) and QBE (QBE).
- **Defensives with bottom up drivers.** We have increased our exposure to defensives given the Chinese / stagflation risks.
- **Quality market leaders.** Quality stocks with pricing power can protect earnings during an inflationary period with strong pricing power.
- **Opening up laggards.** While the cyclical recovery might slow if the supply chain constraints accelerate, the economies will continue to open which will present opportunities for those stocks which have been impacted by lockdowns.

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## Key risks

Key risks to the Fund include:

- **Political environment.** The crisis in Ukraine and sanctions against Russia are severely impacting commodities markets, with the potential to destabilise the region and cause global inflationary shocks. Regional tensions with China also continue to pose risks to trade.
- **COVID-19 disruption.** The development of vaccine-resistant COVID-19 variants or sustained supply chain impacts still poses risks, especially with government support mostly withdrawn.
- **Interest rates.** Low interest rates have been a primary driver of markets over the past few years. With markets now pricing monetary tightening, changes to this trajectory or further inflationary shocks would have a significant impact on valuations.
- **Global growth.** Sanctions against Russia are driving up energy prices and creating global energy security concerns. Historically, sustained price shocks in oil have impacted global growth and catalysed recessions.

## Stock moves

### Sale of Coles Group (COL)

We have exited our position in Coles Group (COL). Supermarkets are lapping tailwinds from COVID-19, and the reopening from the latest Omicron surge is giving way to increased mobility and eating out. Whilst working from home trends are likely to linger, a return to the office in coming quarters will further ease benefits realised from home meals. Labour shortages and supply chain disruptions are expected to negatively impact food retail in the near term. We also see execution risk on ambitious ecommerce infrastructure / supply chain projects, with key initiatives already delayed and at risk of cost blowouts. Despite food inflation benefits being realised, increased online penetration and competition is likely to further offset some margin benefits in the medium term. Whilst valuation is fair, we see better risk / return opportunities elsewhere.

## Investment philosophy

DNR Capital believes a focus on quality businesses will enhance returns when it is combined with a thorough valuation overlay. We seek to identify quality businesses that are mispriced by overlaying a quality filter, referred to as the 'quality web', with a strong valuation discipline. The portfolio is high conviction and invests for the medium term.

## Investment strategy

The DNR Capital Australian Equities High Conviction Fund has an investment style best described as 'style neutral'. The security selection process has a strong bottom-up discipline and focuses on buying quality businesses at reasonable prices. We define quality businesses as being those with the following five attributes:

- earnings strength (particularly improving return)
- superior industry position
- a sound balance sheet
- strong management
- low environmental, social and governance (ESG) risk.

Where we are satisfied that a company possesses quality characteristics, then it is eligible for inclusion in the Fund. However, it must also represent value and sit comfortably within our portfolio construction requirements.

A range of valuation methodologies are used depending on the nature of the company being assessed to identify mispriced opportunities.

The portfolio construction process is influenced by a macroeconomic appraisal and also considers the risk characteristics of the portfolio, such as stock and sector correlations.

## Platform access

- Asgard
- BT Panorama
- Colonial First State FirstWrap
- HUB24
- Macquarie Wrap
- My North & North
- Netwealth
- Wealth O2



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